

***United States Court of Appeals
for the Second Circuit***



**PETITION FOR
REHEARING
EN BANC**

ORIGINAL

77-6104

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

1/4/79

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ALFRED KIRSHNER,

Plaintiff-Pro Se-Appellant,

v.

UNITED STATES OF AMERICA, SECRETARY OF
TREASURY, COMMISSIONER OF THE IRS, ALVIN
D. LURIE, in his capacity as Assistant
Commissioner, Employer Plans and Exempt
Organizations, IRS, BERNARD GOLDBERG,
REUBEN MITCHELL, JOSEPH SHANNON, ROBERT
CHRISTEN, VICTOR CONDELLO, HARRISON J.
GOLDIN, JAMES REGAN, individually and
as Trustees of the Teachers Retirement
System of the City of New York and
ISAIAH ROBINSON, individually as former
Trustee of Teachers Retirement System,

Defendants-Appellees.

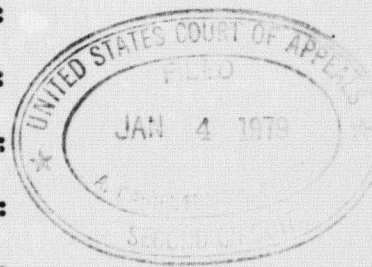
ON APPEAL FROM A JUDGMENT OF THE
DISTRICT COURT FOR THE SOUTHERN
DISTRICT OF NEW YORK
----- x

PETITION OF APPELLEES, TRUSTEES
OF TEACHERS' RETIREMENT SYSTEM,
FOR REHEARING, WITH A SUGGESTION
FOR REHEARING EN BANC

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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Plaintiff-Pro Se-Appellant, :

v. :

UNITED STATES OF AMERICA, SECRETARY OF :
TREASURY, COMMISSIONER OF THE IRS, ALVIN :
D. LURIE, in his capacity as Assistant :
Commissioner, Employer Plans and Exempt :
Organizations, IRS, BERNARD GOLDBERG, :
REUBEN MITCHELL, JOSEPH SHANNON, ROBERT :
CHRISTEN, VICTOR CONDELLO, HARRISON J. :
GOLDIN, JAMES REGAN, individually, and :
as Trustees of the Teachers Retirement :
System of the City of New York and :
ISAIAH ROBINSON, individually as former :
Trustee of Teachers Retirement System, :

Docket No. 77-6104

Defendants-Appellees. :

ON APPEAL FROM A JUDGMENT OF THE :
DISTRICT COURT FOR THE SOUTHERN :
DISTRICT OF NEW YORK :

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PETITION OF APPELLEES, TRUSTEES
OF TEACHERS' RETIREMENT SYSTEM,
FOR REHEARING, WITH A SUGGESTION
FOR REHEARING EN BANC

TO THE HONORABLE JUDGES OF THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT:

Appellees, the trustees of the Teachers' Retirement
System of the City of New York, petition this Court for rehearing

of its decision dated November 30, 1978, which reversed, in part, an order of the United States District Court for the Southern District of New York (Pierce, D. J.), dismissing the complaint for failure to state a cause of action and for lack of standing to sue. This Court by a 2 to 1 vote held that plaintiff as a beneficiary of a public pension fund has standing on behalf of the fund to bring this action under §17(a) of the Securities Act of 1933 and §10(b) of the Securities Exchange Act of 1934. The Court remanded to the District Court for consideration of plaintiff's claims thereunder and the pendant state claim for breach of fiduciary duty.

On December 8, 1978, the trustees-appellees filed a motion for an extension of time to file a petition for rehearing. The motion was granted and the time for filing the petition extended to January 4, 1979.

This petition seeks rehearing, pursuant to Rules 35 and 40 of the Federal Rules of Appellate Procedure, of that part of this Court's decision holding that plaintiff has standing to sue under the federal securities laws. The trustees-appellees submit that permitting a beneficiary of a public pension fund to bring a derivative suit on behalf of the fund against the trustees of the fund is in conflict with the purchaser-seller

standing limitation enunciated in this Court's decision in Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir., 1952), cert. denied, 343 U.S. 956 (1952) and approved by the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). We further submit that, even if a derivative right of action may be implied under some circumstances where the plaintiff is a member of a pension system, in the instant case plaintiff's allegations set forth, at best, a state law claim for breach of fiduciary duty not cognizable under the federal securities laws, since plaintiff fails to allege, as required by the securities law, any nondisclosure of material information between the purchaser and seller. Moreover, we believe that the decision of this Court is in conflict with the holding of the Supreme Court in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977). For these reasons and because of the importance of this Court's decision as it relates to the thousands of governmental and private pension funds, we urge this Court to grant the petition for rehearing or in the alternative for rehearing en banc.

HISTORY OF CASE

Plaintiff commenced this action pro se in February, 1977, challenging, inter alia, the investments by the New York City Teachers' Retirement System in New York City Serial Bonds during the midst of the City's fiscal crisis pursuant to the

Amended and Restated Agreement dated November 26, 1975 (the "Agreement"). Plaintiff contended that the investments violate §17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

The allegations of the complaint relevant to this petition and the claims under the federal securities laws are as follows: The Teachers' Retirement System is funded by both employee and City contributions. Plaintiff was a member of the Teachers' Retirement System from 1928 to 1953 while employed by the Board of Education. In 1953, upon his retirement, sufficient funds were held by the System to fund a fixed annuity and pension allowance of approximately \$3,000 per annum for him. Since 1953, plaintiff has received and continues to receive the full amount of his pension. There is no question in this case that the amount of plaintiff's retirement allowance is not affected by fluctuations in the value of the securities held by the fund. Rather, appellant argues that if the City becomes insolvent and ceases to make its monthly contributions to the fund and the fund thereafter becomes insolvent, his pension may not be paid.

The System is managed by the Teachers' Retirement Board (the "Board"), which has the exclusive power and discretion to invest the funds of the System pursuant to Section B20-31.0 of the Administrative Code of the City of New York.

On November 26, 1975, the five City pension systems, including the Teachers' Retirement System, several commercial banks, the four sinking funds and the Municipal Assistance Corporation for the City of New York entered into the Agreement

whereby the Board agreed to purchase New York City Serial Bonds in the principal amount of \$860 million by June 30, 1978.

According to the complaint, the banks, "while ostensibly acting as disinterested parties, while using their reputations for fiscal integrity, and sound business judgment to induce the 'TRUSTEES' to purchase \$860 million of NYC serial bonds, failed to make full disclosure of the fact that they had sold over \$2 billion of their NYC short term notes in the previous year." (Compl., p. 6). The banks "fail[ed] to disclose the extent and dollar value of the City Bonds held by them as assets and as trustees and fiduciary for clients, [thereby] concealing material facts that would affect an informed investment decision" (Compl., p. 6).

The complaint also alleges that the members of Board, when entering into the Agreement, "were well aware that buying NYC bonds at that time was wrongful because the City was insolvent. In April 1975 Standard & Poor had completely suspended rating NYC bonds. Moody's had downrated them to unsatisfactory Caa on November 3, 1975...Not one bank, insurance company, investment company, trade union fund or corporation in the USA would at that time advance NYC any funds..." (Compl., p. 10).

The purchase of the City bonds pursuant to the Agreement was contingent upon either the issuance of a ruling by the Internal Revenue Service or the enactment of federal legislation providing that the proposed purchases would not constitute

"prohibited transactions" within the meaning of §503(b) of the Internal Revenue Code and would not affect the tax-exempt status

of the funds under §401(a) of the Code.

The complaint further alleges that on December 4, 1975 the Board requested the necessary rulings from IRS, but in the requests "did not make full disclosure in five instances which indicate violations of Security Exchange laws and regulations 10(b) and Rule 10b-5." (Compl., p. 6). As this Court stated (Opinion, p. 6), the plaintiff alleges that the Board did not disclose that (1) the banks had sold City obligations in the previous year; (2) City serial bonds were to be purchased at par when available at a discount; (3) the purchases would increase fund holdings of City obligations to 32%; (4) the Board intended to sell sound corporate bonds to raise cash to make these purchases; and (5) the purchases were not for the exclusive benefit of the beneficiaries. (Compl., pp. 6-8).

The complaint further alleges that the requested rulings were issued by the IRS, and thereafter the Board sold "sound, liquid, varied, highly-rated corporate bonds" to buy "highly speculative, poorly rated, illiquid, high risk NY City obligations", and purchased "at par \$182 million NYC serial bonds which were available at discounts [of approximately 20%]." The Board voted to purchase these bonds [i]n order to maintain...contract benefits, full employment at high wages and high city pension contributions to benefit the presently employed teachers..." (Compl., pp. 5, 6, 15).

On March 19, 1976, Congress enacted Public Law 94-236, which provided that purchases on or after August 20, 1975 pursuant to the Agreement would not constitute "prohibited transactions" or

alter the tax-exempt status of the funds.

SUMMARY OF ARGUMENT

The trustees-appellees submit that a beneficiary's interest in a public pension fund is not a security within the meaning of the federal securities laws, and, therefore, it was not the intent of Congress to protect a beneficiary's interest in his pension under these laws. Since a beneficiary's interest is not directly protected, no derivative right of action may be implied to protect it indirectly, nor does plaintiff have any ownership interest in the fund sufficient to give rise to a derivative right of action. Furthermore, even if a retired pensioner could under some circumstances sue derivatively on behalf of the fund, plaintiff's allegations of fraud here do not state a claim under the securities laws. Plaintiff alleges that the trustees (the buyer) had full knowledge of the City's (the seller) financial condition before entering into the Agreement. Plaintiff contends that the buyer failed to disclose material information to a third-party, the IRS; significantly, he does not allege that there was nondisclosure between the purchaser and seller of the City bonds. The allegations, at best, state a claim under state law for breach of fiduciary duty by the trustees in purchasing City bonds.

(1)

PLAINTIFF'S INTEREST IN THE
PENSION FUND IS NOT A SECURITY
WITHIN THE MEANING OF THE
SECURITIES LAWS.

There is a question whether plaintiff's interest in his

fund is a security within the meaning of the securities laws. In Daniel v. International Brotherhood of Teamsters, 561 F. 2d 1223 (7th Cir., 1977), the Court held that a union member's interest in an involuntary pension fund was an investment contract to which the securities laws applied. The Supreme Court granted certiorari, 46 U.S.L.W. 3512 (Feb. 21, 1978), and heard oral argument this term. Should the Supreme Court hold that the union member's interest does not come within Section 10(b), it is submitted that the plaintiff's interest in his fund would also not come within the securities laws. It is our position that, if the plaintiff could not challenge the transaction which brought him into the System, he cannot bring a derivative suit on behalf of the System.

Decisions of the Supreme Court indicate that a pensioner's interest is not an "investment contract" and therefore not a security within the meaning of the securities laws. The indicia for an investment contract were set forth in S.E.C. v. Howey, 328 U.S. 293 (1946). In Howey, the Court stated that the applicable criteria include the investor's expectation of profits to be derived from the entrepreneurial or managerial efforts of others. 328 U.S. at pp. 298-299.

In United States v. Forman, 421 U.S. 837 (1975), the Court applied the Howey criteria and held that shares in a cooperative apartment are not governed by the securities laws. The Court noted that the cooperative shareholder did not satisfy the requirement that his investment be made based on an expectation of profit. 421 U.S. at p. 852. The Court rejected the argument

that the "expectation of profit" test could be satisfied by the plaintiff's financial loss in his shares if the cooperative became bankrupt. 421 U.S. at 857. See also, Robinson v. United Mine Workers of America Health and Retirement Fund, 435 F. Supp. 245, 247 (D.D.C., 1977); Hurn v Retirement Fund Trust of Piping, Heating and Plumbing Industry, 424 F. Supp. 80 (C.D. Cal., 1976).

Judge Moore's dissenting opinion in the instant case demonstrates that the plaintiff did not invest in the fund with an "expectation of profit" as required by Howey. Plaintiff continues to receive his fixed pension monthly and has not suffered any loss in value by virtue of the challenged investments by the System. Indeed the amount necessary to fund the plaintiff's pension for his actuarial life has been allocated to the appropriate accounts (Moore, C. J., dissenting opin., p. 1). Furthermore, payment of his retirement allowance is guaranteed under §B20-30.0 of the Administrative Code and may not be "diminished or impaired." Article V, §7 of the New York State Constitution.

(2)

THIS COURT'S HOLDING IS INCON-
SISTENT WITH THE SUPREME COURT'S
DECISION IN BLUE CHIP.

Even if the Supreme Court were to hold in Daniel that a union member's interest in an involuntary pension is a security covered by §10(b), the decision of this Court upholding the pensioner's right to bring a derivative suit in the case at bar is contrary to the Supreme Court's decision in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). In Blue Chip, the

Supreme Court, in affirming the purchaser-seller limitation for standing under §10(b) of the 1934 Act, recognized a derivative right of action by shareholders on behalf of the corporation. 421 U.S. at p. 738. The Court noted that creditors or others related to an issuer could not bring a derivative suit. 421 U.S. at p. 738.

Consistent with the decision in Blue Chip, the Court of Appeals for the Fifth Circuit has held that a debenture holder may not bring a derivative suit under the securities laws. Darrow v. Southdown Inc., 574 F. 2d 1333 (1978). See also, Dorfman v. Chemical Bank, 56 F.R.D. 363, 365 (S.D.N.Y., 1972). At best the plaintiff in the instant case is in the same position with respect to the pension fund as the creditor of a corporation. Under such circumstances, he does not have standing to bring a derivative suit.

These decisions prohibiting a creditor or debenture holder from bringing a derivative suit are consistent with the purpose of the securities laws. The shareholder's equity interest in the corporation is subject to real economic diminution in the event of a fraudulent purchase or sale by the corporation, specifically evidenced by his ability to sell his interest in the market and the potential for loss or reduction of dividends. It is that ownership interest and attendant economic reality which this Court recognized in permitting a shareholder's derivative action as an exception to the Birnbaum rule. See Schoenbaum v. Firstbrook, 405 F. 2d 215 (2d Cir., 1968) (en banc), cert. denied sub nom. Manley v. Schoenbaum, 395 U.S. 906 (1969).

Plaintiff's only interest here is in receiving a fixed retirement allowance periodically. As we noted above, upon the

vesting of plaintiff's interest, his right to receive a pension becomes similar to that of a creditor or a debenture holder. Indeed, his retirement allowance is less subject to risk by virtue of the City's guarantee which cannot be diminished or impaired under the State Constitution.

In its decision in the instant case, this Court cited James v. Gerber Products Co., 483 F. 2d 944 (6th Cir., 1973), and Heyman v. Heyman, 356 F. Supp. 958 (S.D.N.Y., 1973) in support of the proposition that a trust beneficiary may sue under Rule 10b-5. In both bases, as well as in Klamberg v. Roth, 425 F.Supp. 440 (S.D.N.Y., 1976), which is to the same effect, some indication of ownership or real potential for economic loss was present. In each case the plaintiff stood to gain or lose by virtue of the success or failure of the management of the trusts, unlike Kirshner, who has a guaranteed fixed income therefrom. To the extent that James, Heyman or Klamberg can be construed to cover a situation where the plaintiff, as in the instant case, has a fixed income, these cases, as we noted above, are inconsistent with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

Recognition of a derivative right of action based on the attenuated interest of plaintiff in the myriad purchases and sales of the pension fund would give rise to precisely the ills envisioned by the Supreme Court in Blue Chip Stamps, supra. There, the Court expressed grave concern that the expansion of the Birnbaum doctrine would result in baseless, vexatious litigation which would have an in terrorem settlement value. 421 U.S. at p. 741. That concern was recognized by Congress in enacting

provisions limiting the potential for strike suits. See, e.g., Section 11(e) of 1933 Act, 15 U.S.C. 77k (undertaking for costs and attorneys' fees).

The Court further noted that the settlement value of such lawsuits is further enhanced by an "in terrorem increment" by virtue of the potential for abuse of the liberal federal discovery provisions. Id. at 741. The Court went on to state that "[g]iven the peculiar blend of legislative, administrative, and judicial history which now surrounds Rule 10b-5, we believe that practical factors to which we have adverted, and to which other courts have referred, are entitled to a good deal of weight." Id. at 749.

The decision of this Court permitting a derivative suit by pensioners would broaden the purchaser/seller limitation to include not only the 25,000 retirees of the Teachers' Retirement System and the hundreds of thousands of beneficiaries of other pension systems but also bondholders, debenture holders, general creditors and all trust beneficiaries. Furthermore, as we demonstrate below, plaintiff in this case fails to allege any non-disclosure or fraud cognizable under the securities laws, and therefore the implication of a derivative action here is a clear example of the "vexatious litigation" envisioned by the Court in Blue Chip Stamps.

(3)

THIS COURT'S DECISION IS INCON-
SISTENT WITH THE SUPREME COURT'S
DECISION IN SANTA FE.

Even were this Court to find the implication of a deri-

vative right of action appropriate herein, plaintiff has nonetheless failed to state any claim cognizable under the 1933 or 1934 Acts. The decision of the Supreme Court in Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 479 (1977), makes it clear that a mere breach of fiduciary duty, relating to corporate mismanagement, does not constitute a cause of action under §10(b), unless the mismanagement resulted from nondisclosure between the purchaser and seller of securities.

Here, the plaintiff has failed to allege any material nondisclosure which tainted the transaction between the trustees and the City. To the contrary, plaintiff alleges that the trustees had full knowledge at the time of the transactions, including the allegation that "the City was insolvent." Moreover, plaintiff has not named the City as a defendant even though it was the seller of the bond.*

The only allegations in the complaint of nondisclosure by a defendant relate to nondisclosure by the trustees, the purchasers, to the Internal Revenue Service, not a party to the transactions, in the requests for the revenue rulings.** However, as the Court in Santa Fe sets forth, §10(b) is concerned only with nondisclosure between the purchaser and seller involved in the challenged transactions, not with other types of frauds.

*It should also be noted that plaintiff, notwithstanding his allegations of nondisclosure by the commercial banks, has not named them as defendants. Of course, nondisclosure by the banks is not actionable against the trustees.

**In any event, even were the alleged nondisclosure to the IRS deemed relevant under Rule 10b-5, the subsequent enactment of Public Law 94-236 covering purchases after August 20, 1975 renders such nondisclosure immaterial.

430 U.S. at pp. 478-479. See also Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y., 1978).

In short, the gravamen of plaintiff's complaint is that the trustees acted imprudently in purchasing the City bonds and thereby breached their fiduciary duty to the beneficiaries. This is a state law claim and does not state a cause of action under the federal securities laws. Three other beneficiaries of the System also brought an action in the Southern District challenging the purchases by the System of City bonds. Since there was diversity of citizenship, the Court held it had jurisdiction. After a three-day trial, the Court concluded that there had been no breach of fiduciary duty. Withers v. Teachers' Retirement System of the City of New York, 447 F. Supp. 1248 (S.D.N.Y., 1978), appeal pending.

CONCLUSION

The motion for rehearing should be granted, and upon rehearing, the order appealed from should be affirmed in all respects. Failing rehearing and grant of the relief here requested, en banc consideration should be granted.

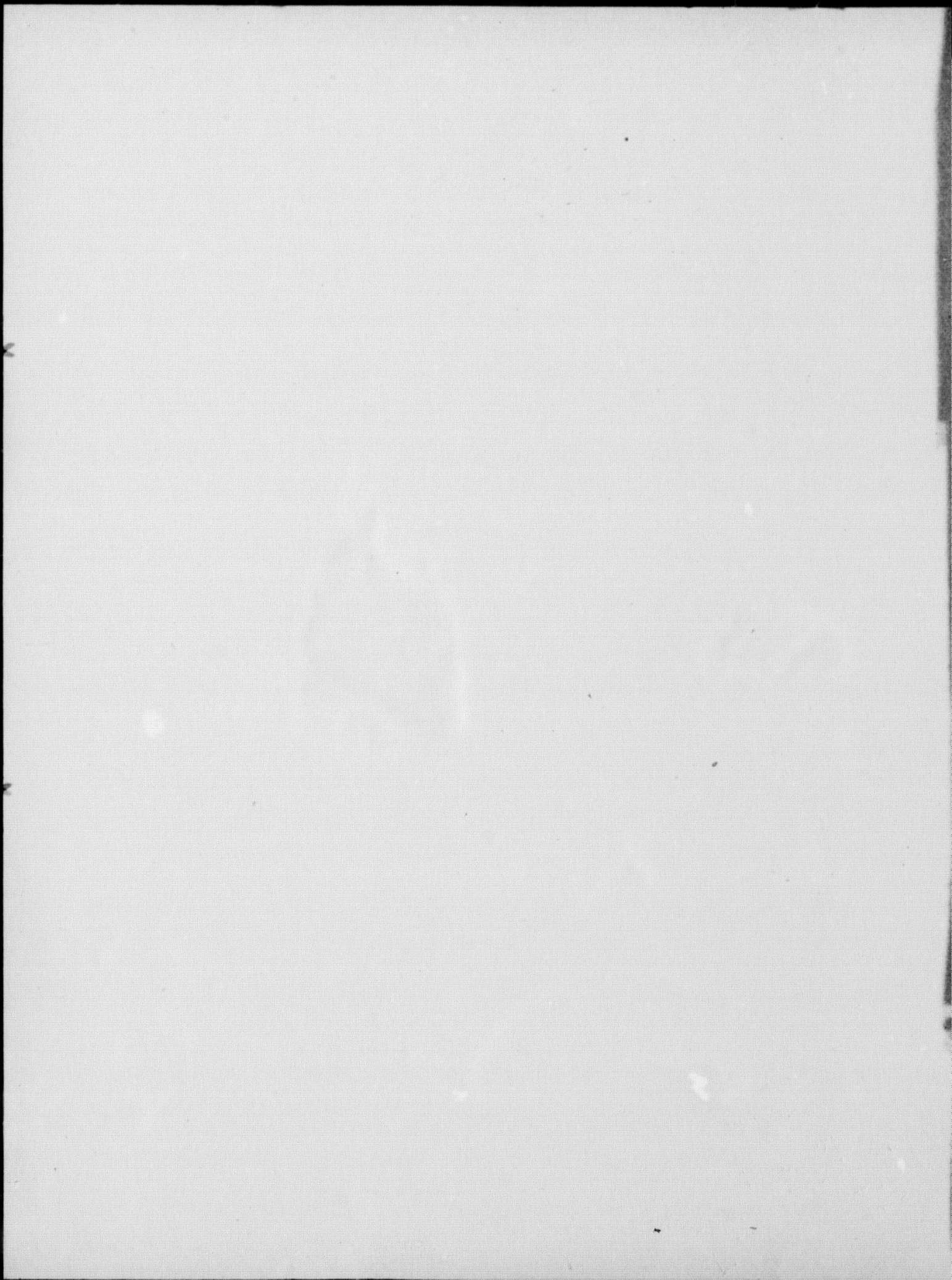
January 4, 1979.

Respectfully submitted,

ALLEN G. SCHWARTZ
Corporation Counsel
Attorney for Defendants-
Appellees, Trustees of
Teachers' Retirement System
of the City of New York.

JAMES G. GREILSHEIMER,
LEONARD KOERNER,
JUDITH A. LEVITT,

Of Counsel.



Plaintiff - Parse
AFFIDAVIT OF SERVICE ON ATTORNEY BY MAIL

State of New York, County of New York, ss.:

Stanley Baruch being duly sworn, says that on the 3 day
of January 1979, he served the annexed Petition of Appellee for Rehearing
of Alfred Pershner Esq., the attorney for the Plaintiff - Parse
herein by depositing a copy of the same, inclosed in a postpaid wrapper in a post office box situated at 100 Church
Street, in the Borough of Manhattan, City of New York, regularly maintained by the government of the United
States in said city directed to the said attorney at No. 98 Van Cortlandt Park in the
Borough of Bronx, City of New York, being the address within the State theretofore designated by
him for that purpose.

Sworn to before me, this

3 day of Jan

1979

Peggy C. Wright
PEGGY C. WRIGHT
Commissioner of Deeds
City of New York No. 4-2073
Commission Expires June 1, 1980

Form 323-70M-714016-4L(79) 346

AFFIDAVIT OF SERVICE ON ATTORNEY BY MAIL

State of New York, County of New York, ss.:

Stanley Baruch being duly sworn, says that on the 3 day
of January 1979, he served the annexed Petition of Appellee for Rehearing
of Robert Stauffer Esq., the attorney for the Plaintiff - Parse
herein by depositing a copy of the same, inclosed in a postpaid wrapper in a post office box situated at 100 Church
Street, in the Borough of Manhattan, City of New York, regularly maintained by the government of the United
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1979

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PEGGY C. WRIGHT
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